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Financial Reporting Implications of a Carbon Price in Australia and International Developments

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Agenda

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- Status of financial reporting for emissions rights
- Issues that may arise during the **fixed price phase** of a carbon tax mechanism and possible accounting treatment
- Discussion in brief of various approaches to account for carbon emissions permits in a **flexible price period**
  - IFRIC 3
  - Net liability approach
- International Developments
  - Lessons learnt on current trends in reporting and disclosure in UK EUETS

Current State of Financial Reporting for Emission Rights

No definitive guidance on accounting for carbon emission permits/rights

At best available guidance include:

- IASB issued IFRIC 3 “Emissions Rights” issued in Dec 2004
  - AASB issued an equivalent UIG 3 in March 2005
  - **Withdrawn** in late 2005 due to mismatches in treatment of assets and liabilities
- Accounting for sulfur dioxide (SO_2) in the US where the Federal Energy Reporting Commission’s uniform systems of accounts require that **emission allowances be recorded at cost** and **not marked-to-market**.

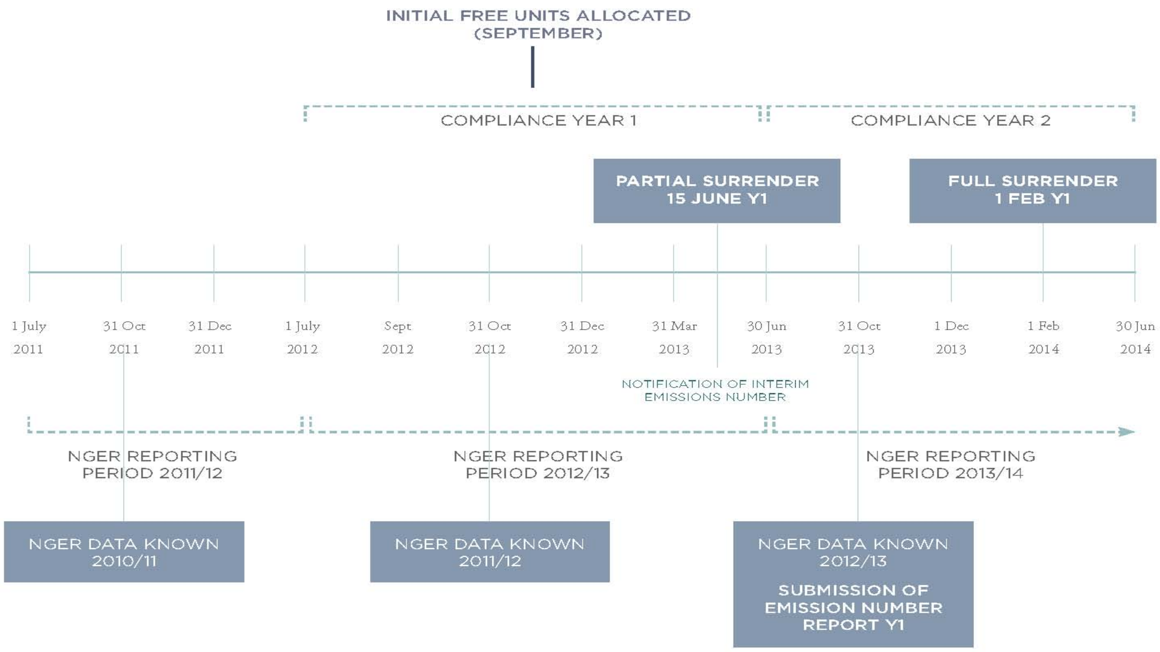
Main concern for Australian reporting entities

- what principles apply to account for transactions that arise the carbon pricing mechanism
  - PwC/IETA (2007) identified 15 approaches to account for emission allowances/permits (6 main approaches if differences in classification are ignored)
  - These finding were reinforced in Lovell et al. 2010
- lack of comparability between companies if they apply different accounting treatments for a similar transaction

Australia during the fixed price phase Liability for Emissions

- commencing 1 July 2012, liable entities will required to accrue a carbon tax payable as emissions take place (AASB 137 *Provisions, Contingent Liabilities and Contingent Assets)* measured at a price of permits used to extinguish the obligation
- based on Scope 1 emissions
- liable entities will be required to report its interim emissions number, being 75% of total provisional emissions numbers
  - calculated on the basis of the previous eligible financial year’s provisional emissions number (e.g. as reported under the NGERs)
  - or a reasonable estimate
- one possibility is that 75% will be extinguish in the compliance year and the remaining 25 in the next year with a different vintage
- if the entity has a shortfall and does not surrender, a unit shortfall charge will apply
- further administrative and late payment penalties apply if the entity fails to pay the shortfall charge

Timetable for reporting GHG emissions and surrendering carbon units assuming a 30 June year end



Source: Carbon Market Institute

Australia during the fixed price phase - How will the carbon tax affect liable entities?

- If the tax is incurred to produce a good/asset, the tax is capitalised and reported in the financial statements (Balance Sheet) as part of the underlying asset, for example:
  - Inventory (AASB* 102 Inventories)
  - Property, plant and equipment (AASB 116)
- Other circumstances , the carbon tax is expense as incurred
  - calculated on the basis of the previous eligible financial year's provisional emissions number (e.g. as reported under the NGERs)
  - or a reasonable estimate

* AASB – Australian Accounting Standards Board (All standards are available in www.aasb.gov.au)

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Australia during the fixed price phase - Permits as an Asset

- Non-monetary identifiable asset without a physical substance hence is regarded as intangible asset (AASB 138)
- Purchased and free permits are measured at the official price relevant for the vintage year (i.e. 2012-2013 = $23; 2013-2014 = $24.15 and 2014-2015 =$25.40
  - free permits not-for-profit entities would apply AASB 1004 *Contributions, which would require permits to be recognised at fair value with a credit to income.*
  - free permits for-profit-entities would be subject to AASB 120 *Accounting for Government Grants ....* where there is a choice to recognise a nominal amount (which could be zero) or at fair value (i.e. official price). For the latter it is required to set up deferred income and recognised in the income statement on a systematic basis as emission occurs
- There is no trading, banking and borrowing that will lead to a timing/price mismatch in the balance sheet and the income statement

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Australia during the fixed price phase - Other reporting issues

- Impairment of assets (AASB 136) – cash flows generated is reduced by the carbon tax hence the recoverable amount of an asset may be impaired which could result to a write down of an asset
- Carbon tax could also lead to onerous contracts if the contracts do not include a pass-through clause requiring the liable entity to recognise additional costs (AASB 137)
- Existing liabilities that exclude carbon tax may require additional provision (e.g. Site remediation provisions)

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Flexible Price Period Possible Accounting Treatment – based on UIG 3

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Australian equivalent of IFRIC 3

Applies to cap and trade emission schemes

- other abatement measures not covered, e.g. CDMs, carbon offsets

Allowances/Permits held – treated as an intangible asset (AASB 138)

- Allowances are issued by governments at less than fair value
- Government grant is equal to fair value less amount paid
- Subsequently measured at cost or revalued (through equity)
- No impact on profit and loss
- Subjected to impairment tests at the end of the period and has P&L impact if impaired

Liability/Provision is recognised for obligation to deliver permits/allowances equal to emissions (AASB 137)

- Accrues as CO_2e is emitted
- Recognised at fair value through profit and loss
- Profit and loss impact

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Flexible Price Period Possible Accounting Treatment – based on UIG 3(continued)

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Free permits give rise to deferred income

- Permits are issued at less than fair value this will give rise to a government grant and deferred income until emission occurs
- Deferred income is amortised through profit and loss on a systematic basis
- Issue: What amount should government grants be recognised?

These accounting treatments are plausible but assume that

- Sufficient permits are received
- Market value does not change
- Deferred income is released in line with the emissions produced
- Permits are not impaired

Unintended Consequence: Accounting mismatch

- Allowances (intangible assets) are measured at cost or revalued amount with movements credited to equity
- Liability is measured at fair value with movements to profit and loss

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Flexible Price Period Possible Accounting Treatment - Net Liability Approach

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Plausible approach given that there is no guidance
Generally accepted in EUETS
Emission rights/permits granted are treated as intangible assets
- recorded at nominal amounts at grant date or at fair value
- Nil for rights issued for free (permitted under AASB 120)

Recognition of liability at reporting date, i.e. when actual emissions exceeds rights granted
- AASB 137 (Provisions, Contingent Liabilities and Contingent Assets) requires provision to be recognised when the recognition criteria in the standard are met
  - Obligating event is when the emission is made
  - Recognise liability only when emissions > permits held
  - Measured at existing market price when determined presumably at year-end
  - Shortfall is passed through P&L

Consistent with AASB 120 "Accounting for Government Grants and Disclosure of Government Assistance"

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Lessons learnt from the UK EUETS

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- Lack of guidance results to:
  - Inconsistency in financial reporting
  - Lack of comparability between entities
  - Undermine investors' confidence in a company's strategy and approach to carbon transactions including trading
- Inadequate disclosure on recognition and measurement of carbon emission permits
- Measurement basis varies for a similar element
- Current policies induces volatility in P/L results
- Lack of transparency on who is accountable for covered installations
- Implications/consequences on valuation and pricing of equity securities

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